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Supreme Court of the United States

OCTOBER TERM, 1942.

No. 985

KRESGE DEPARTMENT STORES, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR CERTIORARI.

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Petition for Certiorari.

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No. ....

KRESGE DEPARTMENT STORES, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The petition of Kresge Department Stores, Incorporated, respectfully shows:

A.

Summary Statement of the Matter Involved.

This case arose under the Personal Holding Company Surtax Statute: sec. 351 of the Revenue Act of 1934; c. 277, 48 Stat. 680, 751; 26 U. S. C. A. 331. Under that section the Commissioner determined deficiencies of $15,714.61 for the fiscal year which ended January 31, 1935, and $7,424.25 for the following fiscal year, as well as penalties of $3,928.65 and $1,856.06 for the respective years because of

failure to file personal holding company tax returns (R. 9-10).

In the words of the statute, a corporation is not a personal holding company unless "at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and gains from the sale of stock or securities". This case turns upon the words quoted. Although the Petitioner had upwards of 1,400 stockholders (R. 38), and its stock was listed and actively traded on the New York Stock Exchange (R. 17), more than 50% in value of the stock was owned during the years in question by not more than five individuals, thus meeting the other requirement of the statutory definition.

During the years in question the Petitioner received substantial sums ($61,720.73 and $32,759.42) as a result of operating a buying office in New York City (R. 24). If these sums are recognized as a part of gross income under section 351, then Petitioner is not a personal holding company, because less than 80% of its income, in each year, was derived from interest, etc. The Board of Tax Appeals held that the sums were a part of gross income and decided that Petitioner was not a personal holding company; that there were no deficiencies and no penalties. The decision of the Board was reversed by the Circuit Court of Appeals for the Third Circuit.

The New York City buying office was not operated for direct profit. With very minor exceptions, its services and facilities were used by four department stores located in Chicago, Washington, D. C., Newark, N. J., and Asbury Park, N. J. Through stock ownership the Petitioner was interested, during the years in question, in the corporations

which operated the Washington and Chicago stores. It had previously owned the capital stock of the corporation which operated the Newark store. Payments for services rendered by the buying office were made on a monthly basis to the Petitioner by the four stores. The total amount billed and paid was a sum equivalent to the total costs borne by the Petitioner in operating the buying office. The Asbury Park store paid $100 monthly. The other stores paid the balance of the total charged, the charge to each being a percentage based upon its gross sales in a previous year. The amount paid to the Petitioner by each store was not the exact cost of services rendered to that store by the buying office (R. 53), but the total amount paid by all four stores was equivalent to the total cost of operating the buying office (R. 23-24).

The New York City buying office of the Petitioner was a substantial enterprise. Between 25 and 30 persons were employed during the years in question, the majority of them being buyers. A place of business with approximately 11,000 square feet of floor space was maintained (R. 40-41). There was no store for the sale of goods, but there was a shipping room and storage room (R. 49-50). The primary service rendered by the Petitioner through its buying office was the purchase of goods in the New York market for the stores mentioned. Supplementary services were renderd, as described in the opinion of the Board (R. 22-23). The buying office furnished to the stores a common, conventional type of commercial service (R. 48). One of the corporate purposes of the Petitioner stated in its Certificate of Incorporation was "To act as * * * purchasing agent for domestic and foreign corporations * * *". From the be-

ginning, a main object of the Petitioner was to centralize buying power (R. 20). The New York City buying office had been in existence since 1923 (R. 40), and the business practices described were being followed long before the passage of the personal holding company tax statute. Efficient operation of the buying office benefited the Petitioner by benefiting the two store-operating companies in which it had an interest. Participation of the other two stores produced an advantage by adding purchasing power and reducing overhead (R. 53-54).

None of the store-operating companies had any stock interest in the Petitioner.

B.

Basis Upon Which It Is Contended That This Court Has Jurisdiction.

The statute concerning jurisdiction is Title 28, section 347 (a) of the United States Code, being the Act of February 13, 1925, c. 229, sec. 1, 43 Stat. 938. The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals by an order dated and filed January 12, 1943 (R. 111). On January 26, 1943 a petition for a rehearing was filed (R. 112). The order of the Court denying the petition for rehearing was filed March 17, 1943 (R. 120).

C.

The Questions Presented.

1. Was the Petitioner a personal holding company within the meaning of section 351 of the Revenue Act of 1934?

(a) In particular, were payments made to the Petitioner during the years in question by several department stores a part of "gross income" within section 351, those payments having been made for services rendered and facilities furnished to the stores by the Petitioner through its New York City buying office and the total of all amounts paid by the stores being equal to the costs of the Petitioner in operating the buying office?

2. Is the Petitioner properly subject to penalties for failure to file personal holding company returns (form 1120 H), even though corporation income and excess-profits tax returns (form 1120) were duly filed?

D.

Reasons Relied Upon for the Allowance of the Writ.

1. Conflicts between the decision of the Circuit Court of Appeals in this case and decisions of other circuit courts.

(a) One basis for the court's decision in this case is that the payments made by the stores to the Petitioner were not "gross income" of the Petitioner (R. 110). That holding is in conflict with a decision of the Court of Appeals of the Second Circuit in a case involving payments to a

corporation owning a cooperative apartment house. The "tenants" made payments to the corporation in a total amount equal to the expenses of the corporation. As in the present case, there was no profit or loss, but the payments of the "tenants" were recognized as income of the owning corporation. *Wood* v. *Rasquin,* 97 F. 2d 1023 (memo), affirming 21 F. Supp. 211.

(b) Another basis for the court's decision in this case is found in the following statement from the opinion (R. 110):

> "And a corporation cannot lift itself out of the class of personal holding company simply by causing non-personal holding company income to flow through its treasury, thereby increasing the amount of its gross income."

It has been expressly held by the Circuit Court of Appeals for the 8th Circuit that the personal holding company surtax statute must be literally applied. *Foley Securities Corp.* v. *Commissioner,* 106 F. 2d 731. There the literal application produced a result against the taxpayer. The language quoted above goes far beyond a literal application. It permits elements of gross income to be ignored, although the actual words of section 351 confer no such power.

(c) A very recent decision by the Circuit Court of Appeals for the 9th Circuit conflicts with the result of this case, and other cases, on the question of penalties. *Lane Wells Co., etc.* v. *Commissioner,* decided March 22, 1943. The opinion is not yet reported and is printed as an appendix to the brief accompanying this petition. There the regular corporation form 1120 was filed and it was held that there should be no penalties for failure to file the personal holding company form, 1120 H.

The Commissioner's ruling in the present case (affirmed by the Court) that the penalties automatically followed the failure to file personal holding company returns appears in the record at page 10. The corporation returns on form 1120, duly filed by the Petitioner, are in the record at pages 94 and 98.

2. The case presents an important question of federal law which has not been, but should be, settled by this Court. Are payments received for services rendered (or goods sold, etc.) a part of gross income when the total of the payments is equal to the expenses of the recipient? There are other reported cases which have dealt with this subject under the personal holding company surtax statute.

Andrew Jergens Co., 40 B. T. A. 868;
W. A. Bechtel Co., 42 B. T. A. 927;
General Management Corp., 46 B. T. A. 738;
Woodside Acres, Inc., 46 B. T. A. 1124.

The question is of special importance under the holding company statute, because the burden will be heavy and the hardship great when an operating company is unexpectedly subjected to the surtax.

The question is also of great importance at the present time because of the large number of cost-plus-a-fee war contracts in effect. Concerning such contracts the Income Tax Unit of the Treasury Department has issued a ruling (I. T. 3459, Cumulative Bulletin, 1941-1, p. 236) reading in part, (italics added)

> "In order clearly to reflect the net income, the gross income from the contract and from other contracts of this type, *including the so-called reimburse-*

> *ments of cost*, should be reported by the taxpayer (reporting on the accrual basis) in the returns for the taxable years in which income or expenses accrues, and there should be allowed as deductions therefrom the costs or expenses which are related to such gross income."

To place administrative practices on sound ground where the presently all important cost-plus contract is concerned, it should be finally determined whether payments made to a taxpayer to cover his costs are or are not gross income.

The alternative holding of the Court of Appeals, that a corporation cannot lift itself out of the personal holding company class simply by causing non-personal holding company income to flow through its treasury (R. 110) has been already mentioned. If that holding should be considered alone, it also presents an important question of federal law for review. Many corporations have stock so closely held as to meet the test of the statute. They also have income from royalties, dividends and interest. They are saved from the penal surtaxes of the statute by having income from operating sources. Is the statute to be so broadly construed as to make it possible to ignore the income from operating sources? That is a question of much importance.

Wherefore the Petitioner respectfully prays that a Writ of Certiorari be allowed to review the decision of the Circuit Court of Appeals for the Third Circuit.

KRESGE DEPARTMENT STORES, INCORPORATED

By WARD J. HERBERT,
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